

DEPARTMENT OF STATE REVENUE

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LETTER OF FINDINGS NUMBER: 97-0228 ST

Sales and Use Tax

For The Period: 1993 Through 1995

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ISSUES

I. Sales/Use Tax—Component Parts of Production Machinery

Authority: IC 6-2.5-5.3; 45 IAC 2.3-5-8; Indiana Department of Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983).

Taxpayer protests the imposition of sales/use tax on component parts of production machinery.

II. Use Tax—Testing Equipment

Authority: 45 IAC 2.2-5-8(i)

Taxpayer protests the imposition of use tax quality control testing equipment.

III. Use Tax—Lump Sum Contracts

Authority: 45 IAC 2.2-3-11; Information Bulletin #60

Taxpayer protests the assessed tax on a painting contract.

IV. Tax Administration—Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2

The taxpayer protests the proposed assessment of a negligence penalty.

STATEMENT OF FACTS

Taxpayer manufactures die cast aluminum parts for the automotive industry. Taxpayer melts aluminum alloy and scrap aluminum in its furnaces, pours the aluminum into molds, knocks off excess metal, and finishes by smoothing the castings and cutting certain holes and making screw threadings. More facts will be added as needed.

I. Sales/Use Tax—Component Parts of Production Machinery

In order to keep its manufacturing costs down and keep a high quality standard, the taxpayer upgraded its equipment in 1993. The taxpayer purchased process monitors and an array recorder.

The auditor assessed the process monitors and array recorder because the monitors and recorder do not control the die casting machinery. Paraphrasing the language of the Indiana Supreme Court used in Indiana Dept. of Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983) (codified at 45 IAC 2.2-5-8), taxpayer argues in contrast that the equipment is directly used in the direct production process and is integral and essential to the production process. According to the taxpayer, the process monitors and array recorder have a positive causal effect on the product being produced. The monitors and array recorder measure the cast porosity. In addition, the taxpayer purchased a fluid filter system. The filter system is portable and attaches to the caster via tubing.

The taxpayer argues that the monitors are part and parcel of the machines, that they have no independent function outside of the machines. To buttress this argument, the taxpayer points to the fact that the new process monitors are now sold as part of the machine, *i.e.* the monitors are built into the machinery. Rather than purchase the new machinery, the taxpayer simply updated the machinery with the latest monitors available by removing the old process monitors that were on the machinery.

The auditor assessed use tax per the example set forth in 45 IAC 2.2-5-8(c)(5), emphasizing the fact that the computers (process monitors) must be used to “control and monitor” the production process in order to be exempt. According to the auditor, since the process monitors (and for that matter the array recorder) do not *control* the production process, they are precluded from the exemption. The taxpayer argues that the example given in 45 IAC 2.2-5-8(h)(2) is germane to the issue. Under 45 IAC 2.2-5-8(h)(2), upgrades “adding new elements and features available in state-of-the-art equipment” are exempt from tax.

Although the two regulations appear to be at cross-purposes, they are actually compatible, as the discussion below will show. The example given in 45 IAC 2.2-5-8(c)(5) involves a computer located in a separate room, in a different part of the plant. The computer is connected to the operation via electrical devices. Unlike the above example, the process monitors are physically attached to the actual machinery and therefore are not within the rubric of 45 IAC 2.2-5-8(c)(5).

Instead, the taxpayer argues, the process monitors should be viewed as part and parcel of the machine and not in a piecemeal/aggregate manner.

The taxpayer also argues its fluid filtering system is exempt. The fluid filter system cleans oil used in the

production process that is circulating through the die casting machine. The system is attached to the caster. The taxpayer argues that under 45 IAC 2.2-5-8(c)(3)(A) and (C) the system is exempt.

FINDING

The taxpayer is sustained in part and denied in part. With regard to the process monitors—which are physically attached to the machines—the taxpayer is sustained. The taxpayer upgraded equipment that was originally part of the machinery. The fluid filtering system is also exempt—the regulation explicitly mentions filtering equipment as exempt. With regard to the array recorder the taxpayer is denied. The array recorder is not attached to the machinery, it is a mobile unit. Per the analysis above, the array recorder is taxable since it is: (1) not a component part upgrade (it is not physically part of the machinery); and (2) it does not *control and monitor* per 45 IAC 2.2-5-8(c)(5).

II. Use Tax—Testing Equipment

DISCUSSION

The auditor assessed use tax on the taxpayer's purchase of testing machinery. The taxpayer's quality control process consists of taking a sample of unfinished product every four hours and completing various tests. The auditor characterizes one set of tests performed by the taxpayer as "destructive testing" and therefore as non-exempt. According to the auditor, since Indiana Code 6-2.5 deals with exemptions in the production process, it follows that equipment that destroys tangible personal property is not exempt. The auditor argues that regulation 45 IAC 2.2-5-8(i) makes this distinction when it states that equipment used to test and inspect the product in "the *production* [is] exempt." (emphasis added) The auditor notes that the castings that are tested are destroyed (although they may be salvaged and reused—thus renewing the steps of pre-production, production, and post-production).

The taxpayer also relies on 45 IAC 2.2-5-8(i), but draws a different conclusion from the language of the regulation. The regulation is worth quoting in its entirety:

Testing and inspection. Machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt.

[Example] Selected parts are removed from production according to a schedule dictated by statistical sampling methods. Quality control equipment is used to test the parts in a room in the plant separate from the production line. Because of the functional interrelationship between the testing equipment and the machinery on the production line and because of the product flow, the testing equipment is an integral part of the integrated production process and is exempt.

The taxpayer argues that the underlying rationale of this exemption is to prevent them from investing time and materials on work in-process that may later fail in the marketplace. Taxpayer argues that the testing is "in-process" testing and all that is "destroyed" is the casting form (since the casting is re-melted). The taxpayer argues that its customers—the so-called "Big Three" automakers—require stringent casting specifications. Pursuant to those standards, the taxpayer pulls a casting every four hours to check for porosity. The taxpayer bores and drills the casting, repeating what its customers will do to the casting. If after the testing the sample is within specifications, then the remaining batch is ready to move on. If the sample casting is not per the requisite specifications, then the batch is removed and re-melted.

Given the taxpayers staggered method of sampling (in-process), the functional interrelationship between the testing equipment and the machinery on the production line, the Department finds that the equipment is not "destructive" in nature. The testing is part of the integrated production process.

FINDING

The taxpayer's protest is sustained.

III. Use Tax—Lump Sum Contracts

DISCUSSION

The auditor assessed the taxpayer use tax for a painting project. The taxpayer hired a contractor to prepare a surface in order to have a sign mounted to the side of a building. The preparation work included the plugging and painting of holes where the old sign had been attached.

According to Information Bulletin #60 sales tax is due on contracts that are not for the improvement of realty. The sales tax is due on the "entire contract, regardless of whether it is a lump sum amount or it is broken out between labor and material costs." The taxpayer argues that the contract was for improvement to realty and was a lump sum contract, and therefore the contractor is responsible for any tax due.

The Department notes that since the taxpayer entered into lump sum contracts, the linchpin is whether the painting constitutes an improvement to real estate or realty maintenance. The Department finds that the painting constitutes realty improvement.

FINDING

The taxpayer's protest is sustained.

IV. Tax Administration—Penalty

DISCUSSION

Indiana Code 6-8.1-10-2.1 states, in part, that if “the deficiency determined by the Department was due to reasonable cause and not willful neglect, the Department shall waive the penalty.” Regulation 45 IAC 15-11-2 also states,

(b) “Negligence” on behalf of a taxpayer is defined as the failure to use such reasonable) care, caution, or diligence as would be expected of an ordinary reasonable taxpayer.”

The Department finds that the deficiency was due to reasonable cause and not willful neglect. The taxpayer took prudent care in establishing a use tax accrual system to self-assess tax on taxable purchases.

FINDING

The taxpayer’s protest is sustained.

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